United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-2177

United States Court of Appeals
FOR THE SECOND CIRCUIT

B

Docket No. 74-2177

P/S

In the Matter

of

KINGSBORO MORTGAGE CORPORATION,

Bankrupt.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF APPELLANTS MANUFACTURERS HANOVER TRUST COMPANY and HOWARD F. SUNSHINE, TRUSTEE IN BANKRUPTCY

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3

TABLE OF CONTENTS

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In their main brief the appellants clearly demonstrate that they make no claim to post-bankruptcy interest against the bankrupt estate as such, but that they claim post-bankruptcy interest from dividends payable to the appellee, a junior creditor, pursuant to the appellee's agreement that dividends payable to the appellee shall be paid to the senior creditors until the senior creditors shall have received payment in full of the principal amount of the senior debt, with interest thereon.

In its answering brief the appellee pays no heed to the argument presented in the appellants' main brief. The appellee refuses to differentiate between post-bankruptcy interest on claims against the bankrupt estate and payment of post-bankruptcy interest to a senior creditor out of dividends payable to the appellee as a junior creditor and treats the senior creditors' claim as though it is a claim against the bankrupt estate.

As stated in the main brief, *Vanston Bondholders Protective Committee* v. *Green,* 329 U.S. 156 (1946) and *Nicholas* v. *United States,* 384 U.S. 678, 682 (1966) deal with the claims against the bankrupt estate *per se* The part of the *Vanston* decision quoted by the appellee evidences that the Court was speaking of payment of post-bankruptcy interest *by the debtor.* The same is true of the appellee's quotation from the *Nicholas* case, which refers to the absorption of the assets of a bankrupt estate by payment of post-bankruptcy interest. As appellants stated time and again, in the instant case we are not dealing with the absorption of the assets of the bankrupt estate distributable to the bankrupt's general creditors, but rather with the collection of post-bankruptcy interest from a junior creditor by the application of the distributive share of the bankrupt's estate payable to the junior creditor, pursuant to the clear terms of a consensual agreement providing for such payment.

In re King Resources Company, Index No. 71-B-2921 (D. Colo. 1974) deals with a plan of reorganization in a proceeding under Chapter X of the Bankruptcy Act and the proposal of senior creditors to provide therein for a spin off of preferred stock allocated to the subordinated debenture holders to the senior debt made in consonance with the provisions of the indenture containing the subordination provisions.

Section 221(2) of the Bankruptcy Act (11 U.S.C. 621[2]) provides that the judge shall confirm a plan if satisfied that the plan is fair, equitable and feasible.

In re Credit Industrial Corporation, 366 Fed. 2d 402 (2d Cir. 1966) this Court held that subordination agreements are recognized in bankruptcy whether or not the senior creditors are parties thereto and enforced without proof of reliance thereon by the senior creditors, citing *Bird & Sons Corp.* v. *Tobin,* 78 Fed. 2nd 371, and other cases which

Judge Winner rejected because the senior creditors were not parties to the indentures (*In re King Resources Company,* p. 11). Notwithstanding the explicit provisions of the indentures, Judge Winner held that "arguably, perhaps" the indentures can be read the way senior creditors want to read them, i.e., as subordinating the junior debt to payment of post-petition interest accruing on the senior debt in a reorganization proceeding "but they can also be read as failing to tell" the holders of the subordinated debentures that they would have to pay the senior creditors post-petition interest in the event of reorganization.

Judge Winner referred to *Joe Newcomer Finance Company,* 226 F. Supp. 387 (D.C. Colo. 1964) in which it was stated at page 390 "But Section 65, sub. a, does not prohibit unequal distribution of dividends where there is a priority given by a lawful contractual arrangement between the parties". In *In re Credit Industrial Corporation, supra,* the court after pointing out that in *Joe Newcomer Finance Company, supra,* the subordination agreement itself was invalid, stated at page 409:

> "When a junior creditor establishes that the subordination agreement is unlawful, it may be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate. In cases where the underlying subordination agreement is unlawful, a court is not confronted with the problem of enforcing express contractual provisions but, rather, with the entirely separate problem of determining which general creditors should bear a loss caused by the debtor, a problem which may have to be resolved by reference to equitable principles."

No claim is made here that the subordination agreement is unlawful.

Judge Winner conceded that the question of allocating the distribution on subordinated debt to post-petition interest payable on senior debt is not free from doubt. He then rejected the proposal of the senior creditors by accepting the fallacious reasoning and conclusions of *In re Time Sales Finance Corp.*, 491 Fed. 2d 841 (3d Cir. 1974) and of the District Court in the instant case and on the far-fetched ground that the proposal was inequitable because the subordinated debenture holders did not subordinate their claims to trade creditors and the acceptance of the proposal would result in the debenture holders receiving less pro rata than the trade creditors. He mentioned that *In re Time Sales Finance Corp., supra* was a reorganization (arrangement) under Chapter XI. Sec. 366(2) of the Bankruptcy Act (11 U.S.C. §766 [2]) provides that the court shall confirm the Chapter XI arrangement if satisfied that it is for the best interests of creditors and is feasible, and unlike §221 of the Bankruptcy Act (11 U.S.C. §621 [2]) does not require the court to find additionally that the plan is equitable.

It is specious for appellee to contend that the Senior Creditors' claims are not claims against Bankers Life but are general unsecured claims against the bankrupt estate. As stated on page 8 of appellants' main brief, by virtue of the provisions of the subordination agreement the Senior Creditors became equitable assignees of Bankers Life claim. Paragraph 12(d) of the Subordination Agreement which refers specifically to payment or distribution in respect of the junior debt and which provides that such payment shall be paid directly to the holders of "senior debt" cannot conceivably transform the Senior Creditors' claim into a claim against the estate.

Appellee's complaint that appellants' argument ignores the final paragraph of Section 12 of the Subordination Agreement (20(a)) is insubstantial inasmuch as a plain reading of the entire paragraph, partially quoted by appellee, evidences that it refers to reorganization of the debtor pursuant to the provisions of Chapter X of the Bankruptcy Act and not to bankruptcy or an arrangement of the debtor's debts pursuant to the provisions of Chapter XI of the Act.

Conclusion

Appellee placed its reliance on inapposite cases or cases in which the applicable law was misconceived and misapplied and failed to refute the arguments presented by the appellants. The decision and order of the District Court should be reversed and the decision and order of the Bankruptcy Judge reinstated as urged by appellants.

Respectfully submitted,

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